

Life After LIBOR

Article

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Lenders and borrowers, do your loan documents provide for an alternative financing rate in case LIBOR becomes unavailable? LIBOR, which stands for the “London Interbank Offered Rate,” is the most widely used “benchmark rate” in determining interest rates for debt instruments, including government and corporate bonds, mortgages, student loans, credit cards; as well as derivatives such as currency and interest swaps, among many other financial products. LIBOR is derived from the average estimated interest rates at which the world’s leading banks can borrow from other banks. Following inquiries into illegal manipulation in the rate-setting process and billions of dollars in fines and damage to the reputations of some of the world’s biggest banks, British regulators recently confirmed the scandal-plagued benchmark interest rate will be phased out by 2021 and replaced by a new rate closely tied to more active markets for loan transactions.

In June of this year, the Alternative Reference Rate Committee (ARRC), a group of private-market participants assembled by the Federal Reserve in 2014, recommended the “broad Treasuries repo financing rate” as the preferred alternative to LIBOR, after considering the depth and robustness of the market as well as other factors including regulatory principles. This rate is based on short-term loans known as repurchase agreements or “repo” trades, backed by Treasury securities as collateral. The ARRC emphasized the importance of a replacement benchmark being anchored in active markets and not in expert judgment, noting the replacement rate’s resistance to manipulation and ability to respond to stressed market conditions. The Federal Reserve Bank of New York has proposed publishing the rate in cooperation with the Office of Financial Research.

The runner up in the vote was the UK’s Sterling Overnight Index Average (SONIA), which is based on actual trades in the U.K. overnight unsecured lending and borrowing market. In April this year, the Bank of England announced that SONIA was picked as its preferred interest rate benchmark for use in sterling derivatives and relevant financial contracts.

The ARRC plans to publish its final report later this year before implementation is expected to begin, and the broad Treasury repo financing rate is expected to be available for daily quotes sometime in early 2018. With these timeframes in mind, while it may be premature to amend current transaction documents, lenders and borrowers should review their loan documents to determine if documentation for their LIBOR-based financing, particularly those that mature

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during or after 2021, provides for an alternative reference rate in case LIBOR is not available.

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